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In the Supreme Court of the United States

OCTOBER TERM, 1959.

No. 215

THE DENTON & ANDERSON COMPANY, *et al.*,
Petitioners,

vs.

THOMAS G. KAVANAGH, ADMINISTRATOR,
Respondent.

PETITION FOR WRIT OF CERTIORARI
To the United States Court of Appeals
For the Sixth Circuit.

H. H. HOPPE,
JAMES W. FREY,
Second National Building,
Warren, Ohio,
Attorneys for Petitioners.

HOPPE, DAY & FORD,
Of Counsel.

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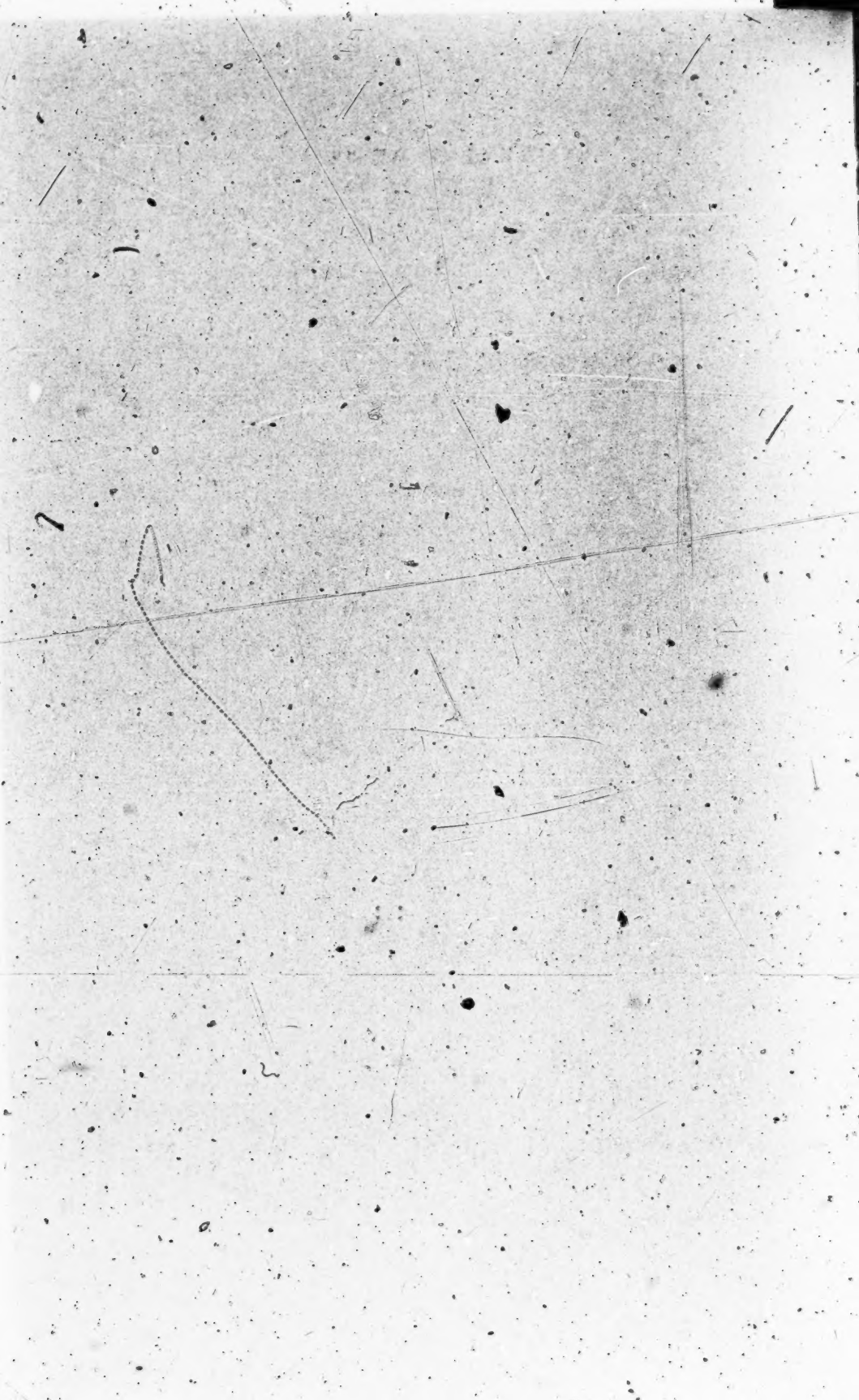

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THOMAS G. KAVANAGH, ADMINISTRATOR,

Respondent.

PETITION FOR WRIT OF CERTIORARI To the United States Court of Appeals For the Sixth Circuit.

Petitioners pray that a writ of certiorari issue to review the judgment of the United States Court of Appeals for the Sixth Circuit entered in the above entitled case on April 22, 1959.

CITATIONS TO OPINIONS BELOW.

The opinion of the District Court (R. 35a-56a)[1] is reported in 164 F. S. 372. No opinion was rendered in the Court of Appeals.

JURISDICTION.

The judgment of the Court of Appeals for the Sixth Circuit was entered on April 22, 1959, and is printed in Appendix B hereto, *infra*, p. 25. The jurisdiction of this Court is invoked under 28 U. S. C. § 1254 (1).

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[1] Reference to the printed record below will be by page number and paragraph number, if there be one, as follows: (R.). Nine extra copies of the record are filed herewith.

QUESTIONS PRESENTED.[1]

1. Whether, upon consolidated tax returns, the deductions by two members of an affiliated group of the entire amount of their losses resulting from their payments to a bank upon a guaranty of a V-loan of a subsidiary affiliate would constitute a "double deduction" to the extent such corporations had availed themselves of the operating loss of the subsidiary in a prior year through the filing of consolidated tax returns?

2. Assuming that the deductions for the guaranty losses are to be reduced by the operating loss of the subsidiary previously availed of by such guarantor corporations, are the deductions of one guarantor corporation to be reduced only to the extent such corporation utilized the operating loss of the subsidiary or may the deductions of one of the guarantor corporations be reduced by the operating loss of the subsidiary previously utilized by it plus a part of such operating loss previously utilized by the other guarantor corporation?

STATUTE AND REGULATIONS INVOLVED.

The statutory provision involved is § 141 of the Internal Revenue Code of 1939, as amended, 56 Stat. 858, 26 U. S. C. (1945 ed.), § 141. The Treasury Regulations promulgated under such statute and here involved are §§ 23.31 (b) and (d) and 23.40 of Treasury Regulations 104 (income tax) and the corresponding sections of Treasury Regulations 110 (excess profits tax).[2] They are printed in Appendix A, *infra*, pp. 16-25.

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[1] The parties stipulated as to the issues involved (R. 34a).

[2] Reference herein will be made only to the applicable sections of Regulation 104 as such sections are substantially identical to the corresponding sections of Regulations 110.

STATEMENT.

This petition is directed to a judgment of the Court of Appeals affirming a judgment for the defendant in the District Court in a suit for recovery of income and excess profits taxes assessed against petitioners for the years 1943, 1944 and 1945. The jurisdiction of the District Court was invoked because the case arises under an Act of Congress providing for internal revenue, 28 U. S. C. § 1340.

The petitioners, The Denton & Anderson Company (referred to herein as "D & A"), The Taylor-Winfield Corporation (referred to herein as "T-W"), and The Warren City Tank and Boiler Company (referred to herein as "Warren City"), were affiliated corporations[1] during the years 1942 through 1945 and filed consolidated tax returns for those years (R. 9a, 7).

T-W purchased all of the stock of Warren City on December 1, 1941 for $327,934.28. On February 13, 1942, Warren City procured a $2,000,000 V-loan from The National Bank of Detroit (referred to herein as the "Bank"), which was guaranteed by the United States Navy and T-W (R. 10a, 10). During the year 1942, Warren City sustained an operating loss of $1,415,380.97. In order to obtain additional working capital and to repay its $2,000,000 V-loan, Warren City procured a $4,000,000 V-loan from the Bank on February 15, 1943, which was likewise guaranteed by the United States Navy and T-W (R. 10a, 11).

The guaranty by T-W of the 1942 and 1943 V-loans of Warren City from the Bank resulted from a requirement of the Bank, as a member bank of the Federal Re-

---

[1] D & A owned 96 per cent of the stock of T-W (R. 9a, 4) and T-W owned all of the stock of Warren City (R. 9a, 5).

serve Bank of Chicago, that V-loans to a subsidiary corporation must be guaranteed by its parent corporation (R. 17a, 31). At the time of the V-loans, T-W was not, either alone, or in conjunction with D & A, in a financial position to lend such money to Warren City, or to so guaranty the credit of Warren City (R. 18a, 32, 33).

Until July 1943, D & A had no connection with the V-loans of Warren City from the Bank. However, D & A was a guarantor of a V-loan of T-W with the Bank, it being the parent corporation of T-W, and by July, 1943, T-W was in default of its V-loan from the Bank (R. 20a). Also by July, 1943, Warren City was in default on its V-loan from the Bank (R. 18a). Accordingly, and at the insistence of the United States Navy, which was the guarantor of both the Warren City V-loan and the T-W V-loan, D & A and T-W were required to enter into an agreement dated July 9, 1943, referred to herein as the "Six Party Agreement" (R. 10a, 13). By the terms of the Six Party Agreement, D & A became a guarantor of the Warren City $4,000,000 V-loan and agreed to pay the Bank thereon 80 per cent of its net annual earnings, but such payments were not to exceed its savings in income and excess profit taxes effected through filing of consolidated tax returns with Warren City and T-W; and T-W agreed to pay 75 per cent of its net annual earnings to the Bank on such V-loan (R. 10a, 13). At the time of the signing of the Six Party Agreement, neither T-W, D & A nor Warren City, either separately or collectively, was in a financial position to pay the $4,000,000 V-loan, nor was there a reasonable likelihood that they would be able to repay such V-loan prior to its maturity on August 31, 1948 (R. 18a, 34).

Between July 9, 1943 and December 31, 1945, T-W paid $473,569.88 to the Bank pursuant to the Six Party

Agreement and during the same period D & A paid $96,213.77 to the Bank pursuant to such agreement (R. 11a, 14).

On February 13, 1944, substantially all of the assets of Warren City were sold to an outsider and until its dissolution on December 30, 1945, Warren City was engaged solely in disposing of its few remaining assets (R. 9a, 3). The proceeds of liquidation of Warren City were insufficient to reimburse D & A for any of its guaranty payments to the Bank of $96,213.77 or to repay a loan of $79,125.53 to Warren City. Nor were such proceeds sufficient to reimburse T-W for any of its guaranty payments to the Bank of $473,569.88, or to pay anything on its stock investment of $327,934.28 in Warren City (R. 12a, 19).

In determining their respective net incomes for the years 1943, 1944 and 1945, D & A and T-W deducted their guaranty payments to the Bank during each year (R. 11a, 18).

We have conceded that D & A was not entitled to deduct the loss on its loan to Warren City in determining its net income, nor was T-W entitled to deduct its stock investment loss in Warren City in determining its net income for the reason that each corporation had previously availed itself of the 1942 operating loss of Warren City in an amount in excess of its losses.

Upon audit of the consolidated tax returns for 1942 through 1945, assessments were made and paid based upon the treatment of the guaranty losses of D & A and T-W in the same manner as the stock investment of T-W in and the loan of D & A to Warren City. The aggregate of such losses was $976,843.46 (R. 14a, 23 (a)) and the Commissioner reduced such aggregate losses by the 1942 operating loss of Warren City availed of by D & A and T-W, collectively, of $779,581.64, thereby allowing only

the excess of such losses, or $197,261.82, as deductible in the year 1945 (R. 14a, 23 (b), (c)). The combined losses of D & A and T-W as so reduced to $197,261.82 were then apportioned between D & A and T-W in the ratio of their respective losses in Warren City to the aggregate of their combined losses in Warren City (R. 14a, 23 (c)) so that, for 1945, D & A was permitted a deduction of $35,404.40 and T-W was permitted a deduction of $161,857.42 (R. 13a, 22).

Thus, T-W was denied a deduction for $311,712.46 of its guaranty payments to the Bank and D & A was denied a deduction for $60,809.37 of its guaranty payments to the Bank.

The case was tried upon a stipulation of facts (R. 8a-33a) and stipulation of issues involved (R. 34a). The District Court held, on the first question, that to allow D & A or T-W to deduct their guaranty losses of 1943 through 1945 without first reducing such losses by the operating loss of Warren City utilized by D & A or T-W in 1942, would amount to a "double deduction" prohibited under the authority of *Charles Ilfeld Company v. Hernandez*, 292 U. S. 62, 54 S. Ct. 596 (1934) (R. 44a-45a). The District Court's reason for relying on this authority is stated (R. 46a-47a):

> "In effect, the guaranty payments to the Bank constituted an investment in Warren City, and should be treated in the same manner as stock investments and advances. D & A and T-W, because of the guaranty payments, now stand in the shoes of the principal creditor, the Bank, and should be treated as though they had loaned money directly to Warren City."

On the second question, the District Court likewise held that the adjustments of the guaranty losses of D & A and T-W were not to be limited to the portion of the

1942 operating loss of Warren City utilized by each corporation, because to do so would permit a "double deduction" within the meaning of the *Charles Ilfeld Company v. Hernandez, supra* (R. 49a-56a).

The Circuit Court of Appeals affirmed the judgment of the District Court for the same reasons, Appendix B, *infra*, pp. 25-26.

REASONS FOR GRANTING CERTIORARI.

For a quarter of a century prior to the decision of the lower court in this case, the manifest difficulty of interpreting and administering the Commissioner's regulations governing consolidated returns had been aided by two principles laid down by this Court: (1) that although losses resulting from intercompany transactions are to be recognized, *Burnet v. Aluminum Goods Mfg. Co.*, 287 U. S. 544, 53 S. Ct. 227 (1933), such recognition cannot result in a "double deduction" *Charles Ilfeld Company v. Hernandez*, 292 U. S. 62, 54 S. Ct. 596 (1934); *McLaughlin v. Pacific Lumber Co.*, 293 U. S. 351, 55 S. Ct. 219 (1934), and (2) that notwithstanding the filing of consolidated returns, each member of the affiliated group remains the "taxpayer" within the meaning of the Internal Revenue Code which is entitled to certain deductions and the affiliated group does not become the "taxpayer," i.e., the separate identity of the members of the affiliated group must be recognized, *Woolford Realty Company v. Rose*, 286 U. S. 319, 52 S. Ct. 568 (1932).

We submit that the courts below misunderstood and, consequently, misapplied the principle prohibiting "double deductions" and have repudiated the principle that the separate identity of the members of the affiliated group must be recognized.

In view of the approval by the lower courts of the action of the Commissioner of Internal Revenue of misapplying and repudiating these two major principles in the consolidated tax field and of interpreting one of his own regulations (§ 23.40) in a manner incompatible with a logical interpretation of his regulations as a whole and incompatible with the history of such regulation *for the sole purpose of making the taxes payable upon the consolidated returns commensurate with the taxes due if separate returns were filed*, it is in the interest of all corporations which now, or in the future may wish to, file consolidated returns that this Court reaffirm or repudiate these principles and approve or disapprove the Commissioner's *present* interpretation of his regulations.

It seems apparent that the Commissioner's position in this case has been to eliminate, by unwritten administrative fiat, any tax advantage accruing to a group of affiliate corporations filing consolidated tax returns even though one member of the group has a large operating loss and the others have taxable incomes. If the courts are to give judicial sanction to this position of the Commissioner, there remains little reason why any affiliated group of corporations would elect to file consolidated returns and pay an additional two per cent surtax.

Further the result of the misapplication and repudiation of these two principles by the courts below was to make the total tax payable by T-W greater than the tax it would have paid if it had filed separate tax returns. T-W paid $327,934.28 for the stock of Warren City and paid $473,569.88 to the Bank under the Six Party Agreement, a total expenditure from its treasury of $801,504.16. For the losses resulting from these expenditures, T-W was only permitted to deduct $161,857.42 in determining its net income (R. 13a-14a, 23); consequently, T-W was denied a

deduction for $639,646.74 of its losses. The denial is purportedly justified by the fact that T-W availed itself of the 1942 operating loss of Warren City. But T-W utilized not more than $459,983.69 of the operating loss of Warren City.[1] Thus T-W has been denied a deduction for at least $179,663.05 of its losses which cannot be justified on the basis it had utilized the operating loss of Warren City to offset its otherwise taxable net income. This results primarily from the lower court's repudiation of the principle that the separate identity of the members of the affiliated group must be recognized for tax computing purposes. The reaffirmation of this principle is of particular importance today because of the change made in the Internal Revenue Code of 1954 (§ 1504) which permits a corporation to join in filing a consolidated tax return if the minority shareholders' interests in such corporation are less than 20 per cent. Today, with an identical factual situation except that D & A owns only 80 per cent of the stock of T-W, consolidated tax returns could be filed but the minority shareholders' interests in T-W would be diluted to the extent of their proportionate share of the undeductible losses ($179,663.05) less the tax otherwise due on such amount. Thus it is plainly in the public interest for protection of the interests of minority shareholders of corporations eligible to

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[1] The 1942 combined net incoms of T-W ($459,983.69) and D & A ($358,806.06) was $818,789.75 while the net operating loss of Warren City availed of by T-W and D & A, collectively, only aggregated $779,581.64 (R. 11a, 15). Because the net operating loss utilized by D & A and T-W was less than D & A's and T-W's combined net incomes in 1942, T-W cannot be charged with utilizing the operating loss to the extent of its entire net income and under the rule in *Bush Terminal Buildings Co. v. Commissioner*, 7 T. C. 793 (1946), acq. C. B. 1947-2, p. 1., for apportioning the operating loss of an affiliate utilized by two or more affiliates having net incomes, T-W would be charged with having utilized $447,713.74 of Warren City's operating loss rather than $459,983.69.

file consolidated tax returns that this Court reaffirm the underlying principle in *Woolford Realty Company v. Rose*, 286 U. S. 319, 52 S. Ct. 568 (1932).

No Double Deduction Is Involved.

The history of the principle prohibiting a "double deduction" in the consolidated tax field starts in 1933 with the case of *Burnet v. Aluminum Goods Mfg. Co.*, 287 U. S. 544, 53 S. Ct. 227 (1933), affirming 56 F. 2d 568, wherein this Court held that a realized loss resulting from an "intercompany transaction" must be recognized, notwithstanding the prior practice of the Treasury to disallow all such losses (See 56 F. 2d 568, 570) and consequently, the taxpayer was entitled to deduct that portion of its losses on its investments in and loans to a subsidiary in excess of the operating losses of such subsidiary which the taxpayer had utilized to offset its own net income in prior years through consolidated tax returns.

In the following year, this Court decided two cases, to wit, *Charles Ilfeld Company v. Hernandez*, 292 U. S. 62, 54 S. Ct. 596 (1934) and *McLaughlin v. Pacific Lumber Co.*, 293 U. S. 351, 55 S. Ct. 219 (1934), in each of which cases, the taxpayer corporation attempted to deduct its losses on its investments in and loans to a subsidiary notwithstanding it had utilized the operating losses of such subsidiary in prior years through consolidated tax returns to an extent greater than such intercompany losses. This Court held that deductions for losses on stock investment in or loans to a subsidiary would constitute a "double deduction" to the extent that the taxpayer corporation had utilized the operating loss of such subsidiary in prior years for the reasons that the deduction of such intercompany losses would be a second use, but in another form, of a loss arising from the same diminution of assets. In *McLaughlin*

v. Pacific Lumber Co., 293 U. S. 351, 356, 55 S. Ct. 219, 221, the Court held that the burden was upon the taxpayer—

> "to show that allowance of a deduction claimed would not amount to twice subtracting the same loss. This is an essential fact which cannot be assumed. Respondent may not rely on mere assertion or speculation (citing authorities).
>
> "The evidence not only fails to establish that essential fact, but is little, if any, less than enough to show that *the allowance of the deductions claimed would be a second use of the same losses.*" (Italics ours.)

The losses evidenced by the assets expended by D & A and T-W and giving rise to the guaranty losses were not and could not be the same losses as evidenced by the assets expended by Warren City and giving rise to its operating loss. The 1942 operating loss of Warren City resulted from its expenditure of its loan from the Bank and therefore it is the diminution of those assets of which D & A and T-W availed themselves by filing consolidated tax returns. Obviously the guaranty losses involved a diminution of entirely different assets as they resulted from payments made by D & A and T-W in years subsequent to 1942 and such payments were to the Bank, not Warren City. Thus the allowance of deductions for the guaranty losses would not be a second use of the same losses.

Regulations Authorize Full Deduction of Guaranty Losses.

The purported authority under the Commissioner's regulations for denying a full deduction for the guaranty losses is § 23.40 which requires an adjustment of any intercompany bad debts for the operating loss of the debtor affiliate previously utilized through consolidated returns by the creditor affiliate. The predecessor of § 23.40, Article 40 of Regulations 75 was promulgated following *Burnet v.*

Aluminum Goods Mfg. Co., 287 U. S. 544, 53 S. Ct. 227 (1933). It is limited to deductions for bad debts resulting from "intercompany transactions" as is evident from this Court's statement in *Charles Ilfeld Company v. Hernandez*, 292 U. S. 62, 66, 54 S. Ct. 596, 598, wherein it is stated—

> "Article 40(a) directs that *intercompany accounts* receivable or other obligations which are the result of *intercompany transactions* during a consolidated return period shall not 'during a consolidated return period' be deducted as bad debts. Subdivision (c) governs deductions after the consolidated return period on account of such transactions during the period." (Italics ours.)

(See also last sentence of Section 23.35, Reg. 104, pp. 23-24, *infra*.)

The only basis for claiming that these losses resulted from intercompany transactions and thereby make § 23.40 applicable is that immediately *after* D & A and T-W made the guaranty payments to the Bank, by operation of the doctrine of subrogation, Warren City became indebted to D & A and T-W to the extent of such payments. However, this does not convert a transaction with the Bank into a transaction with Warren City. When D & A and T-W made the guaranty payments to the Bank, there was no way that they could extricate themselves from the position of becoming, by operation of law, creditors of Warren City. The creation of such a debtor-creditor relationship between a parent corporation and its subsidiary under such circumstances would not permit a manipulation of income which would tend to avoid the tax liability either of the individual corporations involved or of the group as a whole which is the underlying purpose of the regulations, *Burnet v. Aluminum Goods Mfg. Co.*, 287 U. S. 544, 549, 53 S. Ct. 227, 230 (1933). In other words, this situation was not one in which the members of the affiliated cor-

poration can transfer assets from one to the other for the purpose of distorting their respective incomes because the transfer, which is the *sine qua non* of the loss, was to the Bank. Obviously this reliance of the lower courts upon legalisms rather than the substance of the transaction is contrary to an elementary principle of taxation,[1] *Higgins v. Smith*, 308 U. S. 473, 60 S. Ct. 355 (1940); *Commissioner v. Court Holding Co.*, 324 U. S. 331, 65 S. Ct. 707 (1945) and certainly does not change the intent and purpose of § 23.40 as evidenced by its history and logical interpretation.

Section 23.40 is nothing more than an administrative regulation designed to eliminate any "double deduction" resulting from intercompany transactions adopted in compliance with the decisions of this Court in *Burnet v. Aluminum Goods Mfg. Co.*, 287 U. S. 544, 549, 53 S. Ct. 227, 230 (1933) and *Charles Ilfeld Company v. Hernandez*, 292 U. S. 62, 66, 54 S. Ct. 596, 598. However, its manifest purpose, as disclosed by its history and in context with the rest of the Commissioner's regulations, has been distorted to handle the deduction of these guaranty losses for the sole purpose of making the taxes paid upon the consolidated returns commensurate with the total taxes due if separate returns had been filed.

Section 23.31(b)(1) states that the consolidated net income shall be the combined net incomes of the affiliated corporations. Section 23.31(d) establishes the manner of annually computing the net income of each corporation. It basically provides that such net income

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[1] The form as well as the substance of this transaction is a guaranty and not a direct loan as it was stipulated that the guaranties of the V-loans by T-W resulted from a requirement of the Bank that such loans be guaranteed by the parent corporation and at the time of the V-loans and Six Party Agreement, T-W and D & A, neither singly nor collectively, were in a financial position either to lend the money to Warren City or guarantee its credit (R. 17a-18a, 31-33).

> "shall be computed in accordance with the provisions covering the determination of net income of separate corporations, except (i) there shall be eliminated unrealized profits and losses in transactions between members of the affiliated group."

There being no intercompany transaction involved in the guaranty losses, they were not to be eliminated. Even if they would otherwise have been intercompany losses, the last paragraph of § 23.31(d) prevents their elimination as it states:

> "Intercompany profits and losses which have been realized by the group through final transactions with persons other than members of the group * * * shall not be eliminated."

The Bank was not a member of the affiliated group and the *sine qua non* of the guaranty losses were the payments by D & A and T-W to the Bank.

The Affiliated Group Is Not A "Taxpayer."

On the second issue in this case, the holding of the District Court affirmed by the Court of Appeals was that the guaranty losses of T-W are to be reduced not only by the operating loss of Warren City availed of by it, but also by part of the operating loss availed of by D & A. This holding is in direct conflict with the principle enunciated by this Court in *Woolford Realty Company v. Rose*, 286 U. S. 319, 52 S. Ct. 568 (1932) that the separate identity of the members of the affiliated group must be recognized. See also *Commissioner v. Ginsburg Co.*, 54 F. 2d 238 (C. C. A. 2, 1931). This holding is likewise in direct conflict with the rule set forth in *Bush Terminal Building Co. v. Commissioner*, 7 T. C. 793 (1946), Commissioner's acquiescence noted in C. B. 1947-2, p. 1.

CONCLUSION.

For the foregoing reasons, this petition for certiorari should be granted.

Respectfully submitted,

H. H. HOPPE,
JAMES W. FREY,
Counsel for Petitioners.

HOPPE, DAY & FORD,
Second National Building,
Warren, Ohio,
Of Counsel.

APPENDIX A.

STATUTES INVOLVED.

Revenue Act of 1939, as Amended.

Sec. 141. Consolidated Returns.

(a) Privilege to File Consolidated Income and Excess-Profits-Tax Returns.—An affiliated group of corporations shall, subject to the provisions of this section, have the privilege of making consolidated income and excess-profits-tax returns for the taxable year in lieu of separate returns. The making of consolidated returns shall be upon the condition that the affiliated group shall make both a consolidated income-tax return and a consolidated excess-profits-tax return for the taxable year, and that all corporations which at any time during the taxable year have been members of the affiliated group making a consolidated income-tax return consent to all the consolidated income- and excess-profits-tax regulations prescribed under subsection (b) prior to the last day prescribed by law for the filing of such return. The making of a consolidated income-tax return shall be considered as such consent. In the case of a corporation which is a member of the affiliated group for a fractional part of the year, the consolidated returns shall include the income of such corporation for such part of the year as it is a member of the affiliated group. In the case of a corporation which is not a member of the affiliated group after March 31, 1942, of the last taxable year of such group which begins before April 1, 1942, such corporation shall not be considered a member of the affiliated group for consolidated income-tax-return purposes for such year but shall be considered a member of such group for consolidated excess-profits-tax-return purposes for such year, and the consent required in the case of such corporation

shall relate only to the consolidated excess-profits-tax regulations.

(b) Regulations.—The Commissioner, with the approval of the Secretary, shall prescribe such regulations as he may deem necessary in order that the tax liability of any affiliated group of corporations making consolidated income- and excess-profits-tax returns and of each corporation in the group, both during and after the period of affiliation, may be returned, determined, computed, assessed, collected, and adjusted, in such manner as clearly to reflect the income- and excess-profits-tax liability and the various factors necessary for the determination of such liability, and in order to prevent avoidance of such tax liability. Such regulations shall prescribe the amount of the net operating loss deduction of each member of the group which is attributable to a deduction allowed for a taxable year beginning in 1941 on account of property considered as destroyed or seized under section 127 (relating to war losses), and the allowance of the amount so prescribed as a deduction in computing the net income of the group shall not be limited by the amount of the net income of such member.

(c) Computation and Payment of Tax.—In any case in which consolidated income-tax and excess-profits-tax returns are made or are required to be made, the taxes shall be determined, computed, assessed, collected, and adjusted in accordance with the regulations under subsection (b) prescribed prior to the last day prescribed by law for the filing of such returns; except that the tax imposed under section 15 or section 204 shall be increased by 2 per centum of the consolidated corporation surtax net income of the affiliated group of includible corporations. Only one specific exemption of $5,000 provided in section

710(b)(1) shall be allowed for the entire affiliated group of corporations for the purposes of the tax imposed by Subchapter E of Chapter 2.

(d) Definition of "Affiliated Group."—As used in this section, an "affiliated group" means one or more chains of includible corporations connected through stock ownership with a common parent corporation which is an includible corporation if—

(1) Stock possessing at least 95 per centum of the voting power of all classes of stock and at least 95 per centum of each class of the nonvoting stock of each of the includible corporations (except the common parent corporation) is owned directly by one or more of the other includible corporations; and

(2) The common parent corporation owns directly stock possessing at least 95 per centum of the voting power of all classes of stock and at least 95 per centum of each class of the nonvoting stock of at least one of the other includible corporations.

As used in this subsection, the term "stock" does not include nonvoting stock which is limited and preferred as to dividends.

* * * * *

REGULATIONS INVOLVED.

Regulation 104.

Section 23.31.

(b) Definitions—years beginning after December 31, 1940.—In the case of an affiliated group of corporations which makes or is required to make a consolidated return for any taxable year beginning after December 31, 1940, and except as otherwise provided in these regulations—

(1) The consolidated net income shall be the combined net income of the several affiliated corporations—

* * * * *

(d) Computations—years beginning after December 31, 1940.—In the case of affiliated corporations which make, or are required to make, a consolidated return for a taxable year beginning after December 31, 1940, and except as otherwise provided in these regulations—

(1) The net income of such corporations shall be computed in accordance with the provisions covering the determination of net income of separate corporations, except—

(i) There shall be eliminated unrealized profits and losses in transactions between members of the affiliated group and dividend distributions from one member of the group to another member of the group (referred to in these regulations as intercompany transactions),

* * * * *

Intercompany profits and losses which have been realized by the group through final transactions with persons other than members of the group, and intercompany transactions which do not affect the consolidated taxable net income, shall not be eliminated. As used in this paragraph, the term "net income" includes the case in which the allowable deductions of a member (not including any net operating loss deduction) exceed its gross income.

* * * * *

Sec. 23.34 (As amended by T. D. 5127, Mar. 5, 1942). **Sale of stock—basis for determining gain or loss.**—

(a) Scope of section.—This section prescribes the basis for determining the gain or loss upon any sale or other disposition (hereinafter referred to as "sale") by a corporation which is (or has been) a member of an affiliated group which makes (or has made) a consolidated return for the taxable year 1929 or any subsequent

taxable year, of any share of stock issued by another member of such group (whether issued before or during the period that it was a member of the group and whether issued before, during, or after the taxable year 1929), and held by the selling corporation during any part of a period for which a consolidated return is made or required under these regulations.

* * * * *

(c) Sales which break affiliation made while selling corporation is member of affiliated group.—If the sale is made within a period during which the selling corporation is a member of the affiliated group (whether or not during a consolidated return period), and if, as a result of such sale, the issuing corporation ceases to be a member of the group, the basis shall be determined as follows:

(1) The aggregate basis of all shares of stock of the issuing corporation held by each member of the affiliated group (exclusive of the issuing corporation) immediately prior to the sale, shall be determined separately for each member of the group, and adjusted in accordance with the Code, but without regard to any adjustment under the last sentence of section 113(a)(11) with respect to losses of the issuing corporation sustained by such corporation after it became a member of the affiliated group and included in a consolidated income tax return of the group;

(2) From the sum of the aggregate bases as determined in paragraph (1), there shall be deducted the sum of the losses of such issuing corporation sustained during each of the consolidated return periods (including only the taxable year 1929 and subsequent taxable years) after such corporation became a member of the affiliated group and prior to the sale of the stock to the extent that such losses could not have been availed of by such corporation

as a net loss in computing its net income for such periods if it had made a separate return for each of such periods. For any taxable year in which the group sustained a consolidated loss not availed of in subsequent years as a deduction under net loss provisions, the amount deducted under this paragraph shall be reduced by an amount equal to that proportion of such consolidated loss which the loss of the issuing corporation for the year in which such loss was sustained bears to the aggregate losses of the members to the group;

(3) The sum of the aggregate bases of all shares of stock, after making the deduction under paragraph (2), shall then be apportioned among the members of the affiliated group which hold stock of the issuing corporation, by allocating to each such member that proportion of the sum of the aggregate bases so reduced which the aggregate basis of the stock in the issuing corporation held by such member bears to the sum of the aggregate bases;

(4) The aggregate basis as determined under paragraph (3) for each member of the affiliated group shall then be equitably apportioned among the several classes of stock of the issuing corporation held by such member according to the circumstances of the case—ordinarily by allocating to each class of such stock that proportion of the aggregate basis which the basis of each class of such stock held by it at the time of the sale is to the sum of the bases of the several classes of such stock held by it;

(5) The basis of each share of stock of each class held by a member of the affiliated group shall then be determined by dividing the basis apportioned to such class under paragraph (4) by the total number of shares of such class held by it.

* * * * *

Section 23.34 (as amended by T. D. 5441 February 28, 1945). **Sale of stocks—basis for determining gain or loss.—**

(**Note:** the only possible relevant change made in section 23.34 by T. D. 5441 affects only subsection (c) (2) and for that reason the entire section of the regulations is not reprinted and only subsection (c) (2) is reproduced below.)

* * * * *

(c) (2) From the combined aggregate bases as determined in paragraph (1), there shall be deducted the sum of the losses of such issuing corporation sustained during taxable years for which consolidated income tax returns were made or were required (whether the taxable year 1929 or any prior or subsequent taxable year) after such corporation became a member of the affiliated group and prior to the sale of the stock to the extent that such losses could not have been availed of by such corporation as a net loss or net operating loss in computing its net income for such taxable years if it had made a separate return for each of such years, reduced by any losses of the issuing corporation apportioned under this section to its stock sold or otherwise disposed of in a prior transaction, disregarding any transaction between members of the affiliated group during a consolidated return period which did not constitute a partial liquidation of the issuing corporation. For any taxable year in which the group sustained a consolidated loss not availed of in prior or subsequent years as a deduction under net loss or net operating loss provisions, the amount deducted under this paragraph shall be further reduced by an amount equal to that proportion of such consolidated loss which the loss of the issuing corporation for the year in which such loss

was sustained bears to the aggregate losses of the members of the group for such year;

* * * * *

Sec. 23.35 (As amended by T. D. 5127, Mar. 5, 1942). **Sale of bonds or other obligations—basis for determining gain or loss.—**

In the case of a sale or other disposition by a corporation, which is (or has been) a member of an affiliated group which makes (or has made) a consolidated income tax return for the taxable year 1929 or any subsequent taxable year, of bonds or obligations issued or incurred by another member of such group (whether or not issued or incurred while it was a member of the group and whether issued or incurred before, during, or after the taxable year 1929), the basis of each bond or obligation, for determining the gain or loss upon such sale or other disposition, shall be determined in accordance with the Code (see, particularly, section 113), but the amount of any loss otherwise allowable shall be decreased by the excess (if any) of the aggregate of the deductions computed under paragraph (c)(2) of section 23.34 over the sum of the aggregate bases of the stock of the debtor corporation as computed under paragraph (c)(1) or (d), as the case may be, held by the members of the group. (*See, also, section 23.40, relating to disallowance of loss upon intercompany bad debts.*) (Italics ours.)

Sec. 23.35 (As amended by T. D. 5441, Feb. 28, 1945). **Sale of bonds or other obligations—basis for determining gain or loss.—**

In the case of a sale or other disposition by a corporation, which is (or has been) a member of an affiliated group which makes (or has made) a consolidated income tax return for any taxable year, of bonds or obligations

issued or incurred by another member of such group (whether or not issued or incurred while it was a member of the group and whether issued or incurred before, during, or after the taxable year 1929) and held by the selling corporation during any part of a period for which a consolidated return is made or required under the regulations, the basis of each bond or obligation, for determining the gain or loss upon such sale or other disposition, determined in accordance with the Code, but without regard to any adjustment under the last sentence of section 113(a)-(11), shall be decreased (except as otherwise provided in this section) by the excess, if any, of the aggregate of the deductions computed under paragraph (c)(2) or (d) of section 23.34 over the sum of the aggregate bases of the stock of the debtor corporation as computed under paragraph (c)(1) or (d), as the case may be, held by the members of the group. The adjustment with respect to so much of such deductions as is based upon losses sustained during the taxable year 1929 and subsequent taxable years for which the last day prescribed by law for the filing of the return fell on or before March 1, 1945 (the date on which Treasury Decision 5441 was filed with the Division of the Federal Register) and availed of on consolidated returns filed for such years shall be made only in those cases in which the sales or other disposition of such bonds or other obligations resulted in a loss. (*See, also, section 23.40, relating to disallowance of loss upon intercompany bad debts.*) (Italics ours.)

* * * * *

Sec. 23.40 (As amended by T. D. 5244, March 13, 1943). **Bad debts.**—

(a) **Deductions during consolidated return period.**—No deduction shall be allowed during a consolidated return period to any member of the affiliated group on ac-

count of worthlessness in whole or in part of any obligation (including accounts receivable, bonds, notes, debts, and claims of whatsoever nature) of any other corporation which was a member of the group as of the last day of the taxable year or which was liquidated by the group during such year, except as a loss resulting from a bona fide termination of the business and operations of such other corporation, whether in liquidation or otherwise, in which case the loss will be computed subject to the adjustments specified in Section 23.35, and the provisions of Section 23.36 shall be applicable.

(b) Limitation of allowance after consolidated return period.—With respect to obligations (including accounts receivable) of a member of an affiliated group acquired in any way by another member of the group prior to or during any taxable year subsequent to 1928 for which a consolidated income or excess profits tax return was filed, the adjustments prescribed with respect to the allowance of losses upon the sale of bonds shall be applicable to the allowance of any bad debt deduction for any period subsequent to the consolidated return period. (See section 23.35.)

APPENDIX B.

ORDER OF THE UNITED STATES COURT OF APPEALS FOR THE SIXTH CIRCUIT, FILED APRIL 22, 1959.

Before ALLEN, Circuit Judge, BOYD and MATHES, District Judges.

This appeal arises out of an action for refund of the amounts of certain deficiencies in income and excess profits taxes determined against appellants The Denton & Anderson Company, hereinafter called D & A, and The Taylor-Winfield Corporation, hereinafter called T-W, by appellee's

predecessor, the former United States Collector of Internal Revenue for the District of Michigan, Detroit, Michigan, for the taxable years 1943, 1944 and 1945.[1]

Each of the deficiencies, together with interest, was duly paid and after timely claims for refund were made and denied this action was brought, praying for recovery of the amounts paid in the respective years, together with interest, "or such greater sums" to which appellants might be entitled.

The case was heard upon an extended and detailed written stipulation of facts. The District Court wrote an extensive opinion holding in substance that the Collector properly disallowed certain deductions taken for the taxable years and properly apportioned between appellants D & A and T-W an allowable deduction under Treasury Regulations 104, Section 23.40. An order was entered dismissing the complaint on the merits.

The judgment of the District Court is affirmed upon the grounds and for the reasons stated in the excellent opinion of the District Court, 164 Fed. Supp. 372.

Approved for entry:

FLORENCE E. ALLEN,
United States Circuit Judge.

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[1] By December 30, 1945, The Warren City Tank & Boiler Company, appellant, had sold all of its assets, liquidated, and was dissolved.

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In the Supreme Court of the United States

October Term, 1959

No. 215

THE DENTON & ANDERSON COMPANY, ET AL.,
PETITIONERS

v.

THOMAS G. KAVANAGH, ADMINISTRATOR

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SIXTH CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

OPINIONS BELOW

The opinion of the District Court (R. 35a-56a)[1] is reported in 164 F. Supp. 372. The *per curiam* opinion of the Court of Appeals (Pet. 25-26) is reported in 265 F.2d 930.

JURISDICTION

The judgment of the Court of Appeals was entered on April 22, 1959 (Pet. 25-26), and the peti-

[1] Record references are to the separate "Appendix to Brief of Appellants" filed with the Court of Appeals.

tion for a writ of certiorari was filed on July 16, 1959. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

QUESTIONS PRESENTED

In consolidated income tax returns, two parent corporations took deductions for a subsidiary's operating losses. Subsequently, the parents made payments on their guaranties of the subsidiary's indebtedness, and the subsidiary was liquidated. The following questions are presented:

1. Whether amounts paid by the parents under the guaranties were properly disallowed as deductions on the parents' consolidated returns, on the ground that such deductions would duplicate the deductions previously taken for the subsidiary's operating losses.

2. Whether the deductible losses sustained by the parents upon the liquidation of the subsidiary were correctly determined upon a consolidated rather than an individual basis, where use of the individual basis would permit the affiliated group to obtain a double deduction for the same economic loss.

STATUTE AND REGULATIONS INVOLVED

Section 141 (a), (b), and (d) of the Internal Revenue Code of 1939, and Sections 23.31, 23.34, 23.35 and 23.40 of Treasury Regulations 104 are set forth in the Appendix, *infra*, pp. 12-20.

STATEMENT

This case, which was tried on stipulated facts and issues, involves the consolidated income and excess

profits tax returns filed by three affiliated corporations for the years 1942-1945. (R. 35a). At all relevant times, the Denton & Anderson Company ("D & A") owned 96% of the Taylor-Winfield Corporation ("T-W"), and the latter owned all of the stock of the Warren City Tank & Boiler Company ("Warren City") (R. 9a).

T-W's investment in the stock of Warren City amounted to $327,934.28, and during the period from 1941 to 1943, D&A loaned Warren City $79,125.53. (R. 10a.) In addition, D&A and T-W were required to make guaranty payments to a Detroit bank as sureties on loans which Warren City had obtained from the bank. (R-10a-11a.) During the years 1943-1945, the guaranty payments which D&A made totalled $96,213.77, and those made by T-W totalled $473,569.88. (R. 11a.)

In 1942, Warren City sustained an operating loss of over $1,400,000. (R. 10a.) By filing consolidated returns with Warren City during the years 1942-1945, D&A and T-W were able to deduct $779,581.64 of this loss from their own current income. (R. 11a.) In 1945, Warren City was liquidated, and the proceeds were insufficient to pay any of the claims which D&A and T-W had against their subsidiary arising out of the foregoing loans and guaranty payments, or to return any part of T-W's capital investment in the company (R. 12a). We shall refer to both the claims and the capital investment as "claims." The unsatisfied claims of D & A totalled $175,339.30, and those of T-W totalled $801,504.16 (R. 13a-14a).

On their consolidated returns for the years 1943, 1944 and 1945, D&A and T-W deducted the full amount of their guaranty payments to the bank in the year of payment. (R. 11a-12a.) The Commissioner disallowed the deductions taken in the years 1943 and 1944, but partially allowed the deduction taken in 1945 (R. 12a-13a). He combined the aggregate claims which each corporation had against Warren City, and from this total of $976,834.46 he subtracted $779,581.64, which was the sum of the losses of Warren City that had already been deducted by D&A and T-W in their consolidated returns. (R. 14a.) The balance of $197,261.82 was allowed as a deduction on the consolidated return filed for 1945, and was prorated between D&A and T-W in proportion to their respective claims against Warren City. (R. 13a-14a.)

After paying the resulting deficiencies in full, the taxpayers brought suit for a refund (R. 15a-16a). They contended that the guaranty payments were fully deductible in the years when made, and that, in any event, the Commissioner erred in determining the amount of the allowable deduction for the year 1945 (R. 34a.) In a detailed opinion the District Court sustained the Commissioner's determination in all respects. (R. 35a-56a.) The Court of Appeals affirmed *per curiam* on the opinion of the District Court (Pet. 25-26.)

ARGUMENT

The decision below is correct, there is no conflict, and further review is not warranted.

1. This case involves a correct application of the established principle of tax law which prevents an affiliated group of corporations from taking double deductions for the same economic loss. To prevent such a result in cases where consolidated returns are filed, this Court and lower federal courts have uniformly held that a parent may take a deduction for the loss of money invested in or loaned to a subsidiary only to the extent that the claimed deduction exceeds any operating losses of the subsidiary which have already been deducted from the consolidated income of the affiliated group. *Ilfeld* v. *Hernandez*, 292 U.S. 62; *McLaughlin* v. *Pacific Lumber Co.*, 293 U.S. 351; *Edward Katzinger Co.* v. *Commissioner*, 129 F. 2d 74 (C.A. 7th); *Eljer Co.* v. *Commissioner*, 134 F. 2d 251 (C.A. 3d); *Commissioner* v. *Emerson Carey Fibre Products Co.*, 70 F. 2d 990 (C.A. 10th); *Singer Mfg. Co.* v. *United States*, 87 F. Supp. 769 (C. Cls.). To hold otherwise would mean that an affiliated group of corporations could take a double deduction for one economic loss, since the parent could take one deduction for the operating loss sustained by a subsidiary and another deduction for the latter's inability to repay the funds loaned or invested. *Ilfeld* v. *Hernandez*, *supra*.

In view of the established rule prohibiting such deductions, taxpayers concede (Pet. 5), as they must, that having deducted $779,581.64 of Warren City's operating loss in their consolidated returns, D&A and T-W are barred from taking any further deduction for the loss of the $79,125.53 which D&A loaned directly to Warren City, or the $327,934.28

which T-W invested in the stock of Warren City (R. 10a). However, taxpayers insist (Pet. 10-11) that they are entitled to a full deduction for the amounts they expended by making the guaranty payments on Warren City's behalf. In other words, taxpayers assert that the rule which prohibits double deductions when a parent loans money directly to a subsidiary is not applicable where the parent repays funds that the subsidiary has borrowed from other sources.

The District Court correctly held, however, that there is no real distinction between the two situations. (R. 45a-47a.) From a legal standjoint, D&A and T-W were in precisely the same position after they had paid Warren City's debts as they would have been in if they had loaned the same amount directly to Warren City. *Putnam* v. *Commissioner*, 352 U.S. 82, 85. Furthermore, from an economic standpoint, it makes no difference whether a parent advances cash which a subsidiary later loses in its operations, or pays debts which the subsidiary owes to third parties as a result of unprofitable operations which have already taken place. In either event, the operating loss of the subsidiary is paid for by the parent. To the extent that the parent has deducted the subsidiary's operating loss from its own current income, the parent would get a double benefit if it were allowed to take a further deduction for the amount spent in either providing or repaying the working capital that was lost by the subsidiary.

In the case at bar, D&A and T-W spent a total of $976,843.46 in either providing or repaying the working capital that was lost by Warren City. (R. 13a-

14a.) Since D&A and T-W derived a tax benefit from the loss of $779,581.64 of this capital by deducting Warren City's operating losses from their own current income (R. 14a), a double deduction would result if any part of that $779,581.64 could be deducted again. In other words, the balance of $197,261.82 represents the only part of the loss of D&A and T-W which they had not already deducted through the medium of filing consolidated returns with Warren City. Consequently, by claiming deductions for the full amount of their $569,783.65 guaranty payments (R. 11a-12a), D&A and T-W are seeking to deduct $372,-521.83 which they have already deducted once before. The courts below correctly held that they cannot do this. *Ilfeld* v. *Hernández, supra; McLaughlin* v. *Pacific Lumber Co., supra.*

There is no merit in petitioners' contention (Pet. 11-14) that the applicable Regulations[2] authorize

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[2] Section 141(a) of the Internal Revenue Code of 1939 (Appendix, *infra*, pp. 12-13) grants to an "affiliated group of corporations" the privilege of making a consolidated return in lieu of separate returns, "upon the condition" that all members of the group "consent to all the consolidated income- and excess-profits-tax regulations prescribed under subsection (b)", and provides that "The making of a consolidated income-tax return shall be considered as such consent." Subsection (b) authorizes the Commissioner, with the approval of the Secretary of the Treasury, to promulgate such Regulations "as he may deem necessary" to assure that the income is reported "in such manner as clearly to reflect the income- and excess-profits-tax liability and * * * to prevent avoidance of such tax liability."

Unless otherwise noted, all references to the Regulations will be to Regulations 104 dealing with the income tax. The

such a double deduction. As the District Court correctly stated (R. 40a-41a), the general provisions of Section 23.31(d) of Regulations 104, Appendix, *infra*, pp. 14-15, on which taxpayers rely (Pet. 13-14), are not controlling here because they are not applicable when it is "otherwise provided in these regulations". In the situation here presented, the governing Regulations are those contained in Section 23.40, Appendix, *infra*, pp. 19-20. That section provides that no member of an affiliated group of corporations can take a deduction during a consolidated return period on account of the worthlessness in whole or part of "any obligation (including accounts receivable, bonds, notes, debts, and claims of whatsoever nature) of any other corporation which was a member of the group", except as a loss resulting from termination of the debtor's operations, by liquidation or otherwise, in which case the loss will be deductible subject to the adjustments specified in Section 23.35.[3] Under this regulation, neither D&A nor T-W was entitled to any deduction for worthless claims against Warren City until its liquidation in 1945 (R. 12a), at which time a deduction was allowable only to the extent per-

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comparable sections of Regulations 110 (1941 ed.), dealing with the excess profits tax, are similar in all material respects.

[3] Since the broad language of this regulation covers both voluntary and involuntary claims, there is clearly no merit in taxpayers' assertion (Pet. 11-13) that the regulation is inapplicable to claims arising by operation of law—particularly where the result of such an interpretation would be the allowance of a double deduction. See *Ilfeld* v. *Hernandez*, 292 U.S. 62, 68.

mitted by Section 23.35 of the Regulations, Appendix, *infra*, pp. 18-19.

2. Under Section 23.35, any loss sustained by a creditor affiliate on the disposition of obligations of a debtor affiliate can be deducted only after making the basis adjustments provided by Section 23.34(c) or (d). In turn, Section 23.34(c), Appendix, *infra*, pp, 15-18, provides that "the *combined* aggregate" bases of the obligations in the hands of the creditor affiliates must be reduced by "the *sum* of the losses" of the debtor affiliate which were deducted on consolidated returns and could not have been availed of by the creditor affiliates if consolidated returns had not been filed. (Emphasis added.) As indicated in the Statement, *supra*, p. 4, this is precisely the procedure which the Commissioner here followed. Having determined that the combined claims of D&A and T-W exceeded the sum of their prior deductions for operating losses of Warren City by $197,261.82, the Commissioner then allocated this allowable deduction between D&A and T-W in proportion to their respective claims against Warren City, as provided by Section 23.35(e)(3) of the Regulations.

However, taxpayers assert (Pet. 8-9, 14) that because D&A and T-W were separate corporate entities, the Commissioner was required to reduce T-W's claims against Warren City by the amount of the latter's operating losses previously deducted by T-W, and was required to make a similar separate computation with respect to D&A's claims. As the District Court pointed out, after carefully analyzing the facts (R. 50a-54a), this method of adjustment would mean

that $156,528.60 of the operating loss deduction taken by D&A would not be eliminated from the claims of either D&A or T-W and, therefore, would be deducted a second time from the income reported by the corporations on their consolidated return for 1945. Since one purpose of consolidated returns is to reflect the true net income of the affiliated group (see *Burnet* v. *Aluminum Goods Co.*, 287 U.S. 544), the Regulations properly serve to prevent the group as a whole from taking such double deductions for one economic loss. Having chosen to file consolidated returns, taxpayers cannot now complain because the regulations governing such returns preclude them from utilizing their separate corporate entities in calculating their deductions with respect to the adjustments in question here. See *Greif Cooperage Corp.* v. *Commissioner*, 31 B.T.A. 374, affirmed, 85 F. 2d 365 (C.A. 3d); *Singer Mfg. Co.* v. *United States*, 87 F. Supp. 769 (Ct. Cls.). Petitioners' contention (Pet. 8-9, 13) that they have been denied the advantages of filing consolidated returns ignores the fact, pointed out by the District Court (R. 53a), that by filing such returns they could immediately deduct the losses they sustained because of Warren City's unprofitable operations, instead of having to wait until their claims against Warren City became worthless.

3. There is no conflict. The cases upon which petitioners rely (Pet. 7, 14), where the separate identity of affiliated corporations has been recognized, did not deal with, or question the validity of, the Regulations here involved. *Bush Terminal Building Co.* v. *Commissioner*, 7 T.C. 793, is clearly distinguishable

for the reasons given in the District Court's extended analysis of the case. (R. 54-56a).

CONCLUSION

The petition for a writ of certiorari should be denied.

Respectfully submitted,

J. LEE RANKIN,
Solicitor General.

CHARLES K. RICE,
Assistant Attorney General.

LEE A. JACKSON,
GEORGE W. BEATTY,
Attorneys.

AUGUST, 1959

APPENDIX

Internal Revenue Code of 1939:

SEC. 141 [as amended by Section 159 of the Revenue Act of 1942, c. 619, 56 Stat. 798]. CONSOLIDATED RETURNS.

(a) *Privilege to File Consolidated Income and Excess-Profits-Tax Returns.*—An affiliated group of corporations shall, subject to the provisions of this section, have the privilege of making consolidated income and excess-profits-tax returns for the taxable year in lieu of separate returns. The making of consolidated returns shall be upon the condition that the affiliated group shall make both a consolidated income-tax return and a consolidated excess-profits-tax return for the taxable year, and that all corporations which at any time during the taxable year have been members of the affiliated group making a consolidated income-tax return consent to all the consolidated income- and excess-profits-tax regulations prescribed under subsection (b) prior to the last day prescribed by law for the filing of such return. The making of a consolidated income-tax return shall be considered as such consent. In the case of a corporation which is a member of the affiliated group for a fractional part of the year, the consolidated returns shall include the income of such corporation for such part of the year as it is a member of the affiliated group. In the case of a corporation which is not a member of the affiliated group after March 31, 1942, of the last taxable year of such group which begins before April 1, 1942, such corporation shall not be considered a member of the affiliated group for consolidated income-tax-return purposes for such

year but shall be considered a member of such group for consolidated excess-profits-tax-return purposes for such year, and the consent required in the case of such corporation shall relate only to the consolidated excess-profits-tax regulations.

(b) *Regulations.*—The Commissioner, with the approval of the Secretary, shall prescribe such regulations as he may deem necessary in order that the tax liability of any affiliated group of corporations making consolidated income- and excess-profits-tax returns and of each corporation in the group, both during and after the period of affiliation, may be returned, determined, computed, assessed, collected, and adjusted, in such manner as clearly to reflect the income- and excess-profits-tax liability and the various factors necessary for the determination of such liability, and in order to prevent avoidance of such tax liability. Such regulations shall prescribe the amount of the net operating loss deduction of each member of the group which is attributable to a deduction allowed for a taxable year beginning in 1941 on account of property considered as destroyed or seized under section 127 (relating to war losses), and the allowance of the amount so prescribed as a deduction in computing the net income of the group shall not be limited by the amount of the net income of such member.

[26 U.S.C., 1946 ed., 141(a) and (b).]

* * * *

(d) *Definition of "Affiliated Group."*—As used in this section, an "affiliated group" means one or more chains of includible corporations connected through stock ownership with a common parent corporation which is an includible corporation if—

(1) Stock possessing at least 95 per centum of the voting power of all classes of stock and at least 95 per centum of each class of the nonvoting stock of each of the includible corporations (except the common parent corporation) is owned directly by one or more of the other includible corporation; and

(2) The common parent corporation owns directly stock possessing at least 95 per centum of the voting power of all classes of stock and at least 95 per centum of each class of the nonvoting stock of at least one of the other includible corporations.

As used in this subsection, the term "stock" does not include nonvoting stock which is limited and preferred as to dividends.

[26 U.S.C., 1952 ed., Sec. 141(d).]

* * * * *

Treasury Regulations 104, promulgated under the Internal Revenue Code of 1939:

Sec. 23.31 [as amended by T.D. 5127, 1942-1 Cum. Bull. 117]. *Bases of Tax Computation.*

* * * * *

(d) *Computations — Years Beginning After December 31, 1940.*

In the case of affiliated corporations which make, or are required to make, a consolidated return for a taxable year beginning after December 31, 1940, and except as otherwise provided in these regulations—

(1) The net income of such corporations shall be computed in accordance with the

provisions covering the determination of net income of separate corporations, except—

(i) There shall be eliminated unrealized profits and losses in transactions between members of the affiliated group and dividend distributions from one member of the group to another member of the group (referred to in these regulations as intercompany transactions),

* * * *

Intercompany profits and losses which have been realized by the group through final transactions with persons other than members of the group, and intercompany transactions which do not affect the consolidated taxable net income, shall not be eliminated. As used in this paragraph, the ferm "net income" includes the case in which the allowable deductions of a member (not including any net operating loss deduction) exceed its gross income.

* * * *

Sec. 23.34 [as amended by T.D. 5127, *supra*, and T.D. 5441, 1945 Cum. Bull. 214]. *Sale of Stock —Basis for Determining Gain or Loss.*

(a) *Scope of section.*—This section prescribes the basis for determining the gain or loss upon any sale or other disposition (hereinafter referred to as "sale") by a corporation, which is (or has been) a member of an affiliated group which makes (or has made) a consolidated return for *any taxable year*, of any share of stock issued by another member of such group (whether issued before or during the period that it was a member of the group and whether

issued before, during, or after the taxable year 1929), and held by the selling corporation during any part of a period for which a consolidated return is made or required under these regulations.

* * * *

(c) *Sales Made During Taxable Year for Which Return Required After March 1, 1945, Which Do Not Break Affiliation; and Sales Made at Any Time Which Break Affiliation.*

If the sale is made within a period during which the selling corporation is a member of the affiliated group, whether or not during a consolidated return period, and whether or not, as a result of such sale, the issuing corporation ceases to be a member of the group (not including sales made during a taxable year for which the last day prescribed by law for the filing of the return fell on or before March 1, 1945, if such sale did not break the affiliation), the basis shall be determined as follows:

(1) The aggregate bases of all shares of stock of the issuing corporation held by each member of the affiliated group (exclusive of the issuing corporation) immediately prior to the sale shall be determined separately for each member of the group and adjusted in accordance with the Code, but without regard to any adjustment under the last sentence of section 113(a)(11) relating to losses of the issuing corporation sustained by such corporation after it became a member of the affiliated group.

(2) From the combined aggregate bases as determined in paragraph (1), there shall be deducted the sum of the losses of such

issuing corporation sustained during taxable years for which consolidated income tax returns were made or were required (whether the taxable year 1929 or any prior or subsequent taxable year) after such corporation became a member of the affiliated group and prior to the sale of the stock to the extent that such losses could not have been availed of by such corporation as a net loss or net operating loss in computing its net income for such taxable years if it had made a separate return for each of such years, reduced by any losses of the issuing corporation apportioned under this section to its stock sold or otherwise disposed of in a prior transaction, disregarding any transaction between members of the affiliated group during a consolidated return period which did not constitute a partial liquidation of the issuing corporation. For any taxable year in which the group sustained a consolidated loss not availed of in prior or subsequent years as a deduction under net loss or net operating loss provisions, the amount deducted under this paragraph shall be further reduced by an amount equal to that proportion of such consolidated loss which the loss of the issuing corporation for the year in which such loss was sustained bears to the aggregate losses of the members of the group for such year;

(3) The sum of the aggregate bases of all shares of stock, after making the deduction under paragraph (2), shall then be apportioned among the members of the affiliated group which hold stock of the issuing

corporation, by allocating to each such member that proportion of the sum of the aggregate bases so reduced which the aggregate basis of the stock in the issuing corporation held by such member bears to the sum of the aggregate bases;

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Sec. 23.35 [as amended by T.D. 5127, *supra*, and T.D. 5441, *supra*]. *Sale of Bonds or Other Obligations—Basis for Determining Gains or Loss.*

In the case of a sale or other disposition by a corporation, which is (or has been) a member of an affiliated group which makes (or has made) a consolidated income tax return for any taxable year, of bonds or other obligations issued or incurred by another member of such group (whether or not issued or incurred while it was a member of the group and whether issued or incurred before, during or after the taxable year 1929) and held by the selling corporation during any part of a period for which a consolidated return is made or required under the regulations, the basis of each bond or obligation, for determining the gain or loss upon such sale or other disposition, determined in accordance with the Code, but without regard to any adjustment under the last sentence of section 113(a)(11), shall be decreased (except as otherwise provided in this section) by the excess, if any, of the aggregate of the deductions computed under paragraph (c)(2) or (d) of section 23.34 over the sum of the aggregate bases of the stock of the debtor corporation as computed under paragraph (c)(1) or (d), as the case may be, held by the members of the group. The adjustment with respect to so much of such deductions as is based upon losses sus-

tained during the taxable year 1929 and subsequent taxable years for which the last day prescribed by law for the filing of the return fell on or before March 1, 1945 (the date on which Treasury Decision 5441 was filed with the Division of the Federal Register), and availed of on consolidated returns filed for such years shall be made only in those cases in which the sales or other disposition of such bonds or other obligations resulted in a loss. (See, also, section 23.40, relating to disallowance of loss upon intercompany bad debts.)

Se. 23.40 [as amended by T.D. 5127, *supra*, and T.D. 5244, 1943 Cum. Bull. 439]. *Bad Debts.*

(a) *Deduction During Consolidated Return Period.*

No deduction shall be allowed during a consolidated return period to any member of the affiliated group on account of worthlessness in whole or in part of any obligation (including accounts receivable, bonds, notes, debts, and claims of whatsoever nature) of any other corporation which was a member of the group as of the last day of the taxable year or which was liquidated by the group during such year, except as a loss resulting from a bona fide termination of the business and operations of such other corporation, whether in liquidation or otherwise, in which case the loss will be computed subject to the adjustments specified in section 23.35; * * *.

(b) *Limitation of Allowance After Consolidated Return Period.*

With respect to obligations (including accounts receivable) of a member of an affiliated group acquired in any way by another member of the

group prior to or during any taxable year subsequent to 1928 for which a consolidated income or excess profits tax return was filed, the adjustments prescribed with respect to the allowance of losses upon the sale of bonds shall be applicable to the allowance of any bad debt deduction for any period subsequent to the consolidated return period. (See section 23.35.)

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